| | |
|---|---|
| Attorneys' fees | 11 U.S.C. § 329 |
| Disgorgement | 11 U.S.C. § 330 |
| Laches | 11 U.S.C. § 331 |
| 11 U.S.C. § 105(a) | 11 U.S.C. § 541(a)(6) |
| 11 U.S.C. § 327 | 11 U.S.C. § 549(a) |
| 11 U.S.C. § 328 | Bankruptcy Rule 2017 |

In re Thurmond, Case No. 683-07538-W7

8/29/91 PSH unpublished

Six years after a Chapter 11 case was converted to Chapter 7, the court ordered an attorney and accountant to disgorge funds they had received without prior court approval while employed by the debtor in possession. The court rejected both professionals' arguments that disgorgement was inequitable due to the lapse of time since the payments were first disclosed to the court or that disgorgement was only mandated under § 549(a). The court also rejected the attorneys' argument that disgorgement was inappropriate because the payments were not made from property of the estate as their source was either a prepetition retainer or the debtors' postpetition earnings. The court held that professionals must disclose the receipt of any prepetition retainer or payment, regardless of its source, so the court may determine whether compensation is reasonable, regardless of whether it came from estate property. Besides, the court, not the applicant, determines whether the source of payment is estate property and whether or not prior court approval is needed. Further, whenever professionals for debtors in possession expect to be paid postpetition from any funds generated by the debtor in possession post-petition, they must do three things:

1. If the professional expects to receive a post-petition payment for services previously rendered out of property of the estate, he must seek and obtain prior court approval under § 330.
2. This requirement applies although the professional may believe that the funds from which he is to be paid are excluded from the estate by the provisions of § 541(a)(6). That determination is to be made by the court upon evidence presented by the applicant.
3. If, contrary to these requirements, the professional has received any post-petition payment from the debtor in possession without prior court approval, the professional must restore the funds to the estate before he requests that the court approve any fees for services. Restoration is no guarantee of allowance.

As the applicants did neither of these things, but instead received payment without prior court approval, the payments had

to be refunded, especially since there was insufficient funds in the estate to pay all Chapter 7 administrative claims.

E91-14(31)

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF OREGON

| | | |
|---|---|---|
| IN RE | ) | |
| | ) | |
| ROBERT E. THURMOND and MARILE J. THURMOND, | ) | Case No. 683-07538-W7 |
| | ) | |
| | ) | |
| Debtors. | ) | MEMORANDUM OPINION |

The debtors in possession filed a Chapter 11 bankruptcy petition on May 20, 1983. The case was converted to a Chapter 7 proceeding on May 7, 1985. The history of this case is lengthy, complex and cheerless. As a perhaps predictable end to the case, the present Chapter 7 trustee has filed a final report with the court which indicates there will be insufficient funds in the Chapter 7 estate to pay all allowed Chapter 7 administrative expenses.[1] During the administration of the Chapter 11, two

[1] The trustee has $27,115.05 on hand to pay allowed Chapter 7 administrative claims of at least $40,839.43.

professional Chapter 11 administrative claimants received fees without prior court approval. Based on the analysis which follows I shall require repayment of these fees for distribution to the allowed Chapter 7 administrative expense claimants.

MCGAVIC & BOYD, P.C.

The record of the history of the payments to McGavic & Boyd, P.C. (hereinafter McGavic & Boyd), for their services on behalf of the Thurmonds is unnecessarily complex. They filed the Chapter 11 bankruptcy petition for the Thurmonds on May 20, 1983. After receiving an extension from the court, the debtors in possession filed their schedules and statement of affairs on June 17, 1983. At that time, McGavic & Boyd filed an attorney's disclosure statement of compensation paid or to be paid. This statement provided in relevant part:

> "Debtors have agreed to pay McGavic and Boyd, P.C. on an ongoing basis regular charges based upon the following hourly rates: [Hourly rates then given] . . . .
>
> Debtors have deposited, in the form of a partial retainer, the sum of $5000, and have agreed to deposit the sum of $5000 per month for the next four months until the total retainer of $25,000 has been paid. The fees as calculated above will be charged against the retainer."

On August 16, 1983, the debtors in possession filed an application to employ McGavic & Boyd as their attorneys. Attached to that application was an affidavit of proposed attorney signed by

Keith Boyd stating that he was a disinterested person within the meaning of Section 328(c) [sic].[2] It further stated:

> "I further state that I have discussed how I charge a client for legal services performed with the debtors-in-possession. So as to advise the Court and the debtors, I use the following factors in determining the amount of reasonable attorney's fee to be charged to all clients and charge the cost of comparable services other than in a case under the Bankruptcy Code as follows:
>
> [here the debtors listed the 12 factors enumerated in Johnson v. Georgia Hwy. Express, Inc., 488 F.2d 714, 717-19 (5th Cir. 1974), abrogated on other grounds by Blanchard v. Bergeron, 489 U.S. 87, 109 S.Ct. 939, 103 L.Ed.2d 67 (1989)] . . . .
>
> My normal hourly rate is $100.00 per hour for all clients . . . ."

No other information appeared on the affidavit regarding the proposed fee arrangement with the clients or other possible conflicts. The order of appointment, signed by the court on August 19, 1983, was submitted by Keith Boyd. It contains a finding that the firm of McGavic & Boyd is a disinterested person within the meaning of 11 U.S.C. § 101(13), and states in part, "IT IS FURTHER ORDERED that said attorney's compensation for services rendered shall be determined hereafter by this Court." This order did not have retroactive effect to the date of filing of the petition.

On February 14, 1984, McGavic & Boyd filed their first interim fee application. That application, at pages 3-4, states in part:

---

[2] The court assumes this to be a reference to 11 U.S.C. § 101(13). All statutory references hereinafter are to the Bankruptcy Code, 11 U.S.C. § 101 et seq., unless otherwise indicated.

"6. There have been no promises for payments from any source for services rendered or to be rendered in any capacity whatsoever in connection with this case. . . .

9. Previous applications have been filed, awards made and payments received by your applicant as follows: DATE OF PREVIOUS ALLOWANCE--none; AMOUNT REQUESTED--none; AMOUNT APPROVED--none; AMOUNT ACTUALLY RECEIVED--none . . . .

13. Your applicant has had disbursements in the sum of $255.33 for long distance telephone charges, copy machine usage, travel expenses and the like . . . ."

After itemizing the time spent for professional services rendered, the firm asked the court to allow the sum of $10,375.13 in fees (75% of the itemized time) plus $255.33 in expenses pursuant to § 331. The application does not mention either pre- or post-petition receipt of funds from the debtors in possession nor application of any of these funds toward payment of the firm's fees incurred. It does include an itemization of work done for the Thurmonds from February 7, 1983 through January 20, 1984, which seems to include services performed in anticipation for the bankruptcy filing on May 20, 1983.

Along with the first interim fee application, the firm filed with the court a NOTICE OF INTENT TO PAY INTERIM COMPENSATION AND PRESENT ORDER THEREFOR. It states in part:

"The debtors in possession propose to pay interim compensation pursuant to 11 U.S.C. § 331, to the following persons in the following amounts:

A. MCGAVIC AND BOYD, P.C., attorneys for debtors in possession:

Fees.....$10,375.13
Costs..... 255.33"

After notice of the proposed allowance was sent out, several creditors objected to the payment. On April 10, 1984, at the hearing on these objections, Mr. Boyd appeared and informed the court that his firm had received certain funds from the debtors in possession post-petition and had applied those funds against fees incurred by the debtors in possession. He also indicated that the firm had received a pre-petition payment which had been applied against fees incurred by the debtors pre-petition. This was the first time the court became aware of these facts. The court required the firm to file an amended fee application itemizing the funds received and demonstrating the actual application of any of those funds to the firm's fees incurred either pre-petition or post-petition. The court also raised a question about the failure of the firm to obtain court appointment to represent the debtors in possession until August 19, 1983. In response to the court's concerns, on April 20, 1984, the firm filed a Motion for Nunc Pro Tunc Appointment and a Supplemental and Amended Application for Interim Allowance, along with a Memorandum in Support of Application for Allowance. The Motion for Nunc Pro Tunc Appointment asked the court to modify the court's previous order appointing the firm as attorneys for the debtors in possession by making it retroactively effective to the date the bankruptcy petition was filed. The court has not ruled on this motion.

The April 20, 1984 Supplemental and Amended Fee Application, at p. 2, states in part:

> "2. Up through and including January 20, 1984, your applicant has been paid the following sums at the indicated times:

| DATE | FEES PAID | REIMBURSEMENT OF COSTS | TOTAL AMOUNT |
|---|---|---|---|
| 3/8/83 | $1,000.00 | $ -0- | $1,000.00 |
| 3/25/83 | 1,000.00 | -0- | 1,000.00 |
| 5/20/83 | 985.73 | 214.27 | 1,200.00 |
| 5/26/83 | 1,247.50 | 200.46 | 1,147.96 |
| 6/29/83 | 1,481.75 | 13.52 | 1,495.27 |
| 7/28/83 | 3,013.88 | 20.36 | 3,034.24 |
| 8/22/83 | 1,000.00 | -0- | 1,000.00 |
| 9/26/83 | 379.50 | -0- | 379.50 |
| 10/31/83 | 500.00 | -0- | 500.00 |
| 12/2/83 | 232.00 | -0- | 235.00 |
| 12/29/83 | 345.21 | 4.79 | 350.00 |
| TOTALS: | $11,713.04 | $ 453.93 | $12,166.97 |

> These payments have been made from the retainer payments made by the Debtors-in-Possession as follows:

| | |
|---|---|
| 3/8/83 | $ 1,000.00 |
| 3/17/83 | 1,000.00 |
| 5/20/83 | 1,200.00 |
| 5/20/83 | 2,000.00 |
| 5/20/83 | 3,000.00 |
| 6/29/83 | 2,000.00 |
| 8/22/83 | 1,000.00 |
| 10/24/83 | 1,000.00 |
| | $12,200.00 |

> 3. Based upon the amounts paid to your applicant, your applicant amends its previous APPLICATION to request an allowance be made by this Court for interim compensation and disbursements in the amounts actually received by your applicant, as set forth above."

Although ambiguous, the court interprets this language to mean that the second listed paragraph of columns reflects the dates when the

Thurmonds turned over the stated amounts to their attorneys, and the first listed paragraph of columns reflects when the attorneys, through their internal bookkeeping, actually applied funds from their clients to fees and costs accrued. This comports with the firm's April 20, 1984 Memorandum in Support of Application for Allowance, at page 3, which states: "Of the total sum of $12,166.97 received from the Debtors-in-Possession, $8,200 was actually received prior to the filing of the case and $3,966.97 after." The April 20, 1984 supplemental application asks the court to allow $12,166.97 as interim compensation and expenses.

Several objections were made to the fee application as amended. The substance of the objections was: 1) McGavic & Boyd had taken fees for services rendered without court authorization; 2) funds received by the firm during the stated period of time were diverted from payments to other creditors with the possibility of prejudice to the estate; 3) claims for attorney's services should be disallowed where time was spent on nonlegal matters; and 4) the attorneys had filed misleading documents with the court in relation to their fee application. The objecting party also asked that the court apply sanctions under Bankruptcy Rule 9011. The court made no rulings on the matter at the time.

Between May and November 1984, the reorganization ran into more difficulties and on November 5, 1984 this court appointed a trustee to operate the estate business. On November 29, 1984,

McGavic & Boyd filed an application with the court to represent the debtors out of possession. The court signed this order the same day, nunc pro tunc to November 2, 1984.

The case was converted to Chapter 7 on May 7, 1985. On July 9, 1985, McGavic & Boyd filed a final application for allowance of $42,945.25 in fees and expenses solely for representing the debtors out of possession between November 1984 and July 1985. On July 10, 1985, the firm filed a final application for approval of $28,258.63 in fees and expenses for representing the debtors in possession. This application stated that the $28,258.63 sought included $12,666.97[3] which had already been received by the firm and previously applied for in its second interim fee application. The court did not rule on either application at that time.

In early 1987 this court reviewed these fee applications. Because it still had questions about the information provided earlier by the firm regarding fees arising from representation of the debtors in possession, this court asked Mr. Boyd to file a supplemental memorandum to aid in clarifying the facts. This supplemental memorandum, filed on February 4, 1987, contained the first clear statement that prior to filing bankruptcy, the Thurmonds paid the firm $8,200, and that of this amount, $3,200 was applied by the firm against the debtors' pre-petition bill. It

[3] This figure is $500 greater than the amount stated as being received ($12,166.97) by the firm in its second interim fee application.

further stated that the Thurmonds paid the firm an additional $4,000 post-petition of which $3,966.67 was applied to fees incurred post-petition, with the balance of $33.33 having been paid to third parties for costs.[4]

Since the court had been alerted to the possibility of requiring the Chapter 11 administrative claimants to disgorge funds to the Chapter 7 trustee, this court allowed the firm to file an additional memorandum addressing that issue. In this memorandum, filed on November 20, 1989, Mr. Boyd states his firm received $4,466.97 from the debtors in possession post-petition.[5]

Although the applicant has filed several pleadings with the court regarding services rendered to the Thurmonds from prefiling through the appointment of the Chapter 11 trustee on November 15, 1984, its statements remain confusing. They are confusing because they are contradictory. The first interim fee application (February 14, 1984) filed by McGavic & Boyd states they had received no funds from the debtors in possession, and asked the

---

[4] This memorandum, although filed after the final fee application, argues for approval of the $12,166.97 sought in the second interim fee application rather than the $12,666.97 sought in the final fee application.

[5] This figure is $500 greater than previously asserted, which would apparently account for the discrepancy between the $12,166.97 stated as received by the firm in its second interim fee application and the $12,666.97 stated as received by the firm in its final fee application. However, this memorandum states the firm received $12,166.97 in total compensation from the debtors in possession, and does not mention the $12,666.97 figure from the final fee application.

court to allow and authorize payment of fees in the amount of $10,375.13 (which was 75% of fees incurred of $13,833.50). After it was revealed at the hearing on the objections to the fee application that the firm had actually received significant funds from the Thurmonds both pre- and post-petition and had already applied them to their accrued fees, they filed a second fee application (April 20, 1984) which is different from the first application and, at best, is ambiguous. A careful reading of that application indicates that a total of $12,200 was paid to the firm pre- and post-petition as a "retainer" -- $2,000 pre-petition, $6,200 on the day the Chapter 11 was filed (unstated whether pre- or post-petition) and $4,000 post-petition. The summary of the application of those payments from their clients to McGavic & Boyd indicates they applied $3,200 ($2,985.73 for fees and $214.27 for expenses) to fees and expenses through May 20, 1983 (the petition filing date) and a total of $12,166.97 ($11,713.04 for fees and $453.93 for expenses) to fees and expenses up to the date of the application. The attorneys' disclosure statement, filed June 17, 1983, declares a pre-petition retainer was paid in the amount of $5,000. But the Memorandum in Support of Application for Allowance filed with the second interim fee application states that $8,200 was received pre-petition, and the application itself indicates that $8,200 was received as a retainer as of the filing date and suggests that $3,200 was applied by the applicant to pre-petition

services. Assuming this to be the case this court does not know if such bill represented fees for nonbankruptcy work or fees incurred in preparation for filing bankruptcy.

The applicant's final fee application for services to the debtors in possession (July 10, 1985) is also confusing, internally inconsistent, and inconsistent with the first and second interim fee applications. It supplements the time and expenses stated on the second application, and asks the court to enter an order allowing the total amount of $27,554.50 in fees and $704.13 in expenses. These figures included the amounts prayed for in all prior applications which the firm had paid itself without prior court approval. The final application, at page 5, paragraph 10, states that of the $27,554.50 sought, "$12,213.04 has been allowed and $12,213.04 has heretofore been paid" (emphasis added). This is inconsistent with paragraph 9 which lists the two previous interim fee applications and indicates that $12,166.97 had been previously requested but not approved, although paid. And paragraph 9 is inconsistent with the firm's prayer on page 6 for allowance of the total fee request "of which the total sum of $12,666.97 has heretofore been paid."

In his February 4, 1987 memorandum, Mr. Boyd states that $8,200 was received pre-petition. Further, he states the firm received total compensation from the Thurmonds for services rendered of $12,200. For the first time he clearly states that

$3,200 of the $8,200 received pre-petition was applied to pre-petition debt.[6] He further states that the $8,200, having been paid pre-petition, is not property of the estate and this court therefore cannot order it refunded. He states $4,000[7] was received post-petition of which $3,966.67 was paid to the firm, with the balance expended to third parties for "costs of the Chapter 11." He again asks the court to approve allowance of fees and costs to his firm in the amount of $12,166.97.[8]

McGavic & Boyd have not received any payment, authorized or unauthorized, for their services as attorneys for the debtors out of possession, although significant fees have been requested. Nor has this court ever authorized the payments to them for services as attorneys for the debtors in possession. The firm has asserted several defenses to any order this court might enter requiring them to disgorge funds they received from the Thurmonds. First, they argue that any repayment would be inequitable in this case because of the time which has passed since payments were first disclosed to

---

[6] Although he does not specifically say so, this court assumes the balance of the $8,200 received pre-petition was the $5,000 paid and denominated a "retainer" by the disclosure statement.

[7] The November 20, 1989 supplemental memorandum, at page 4, raises this figure to $4,466.97.

[8] This, of course, is inconsistent with the $12,666.97 stated as actually received by the firm in its July 10, 1985 final fee application for services to the debtor in possession. In the absence of any further explanation of this discrepancy by the firm, the court presumes the higher figure is more accurate.

the court. Second, they argue that post-petition transfers of funds from the debtor in possession to its attorney are subject to recovery only under § 549(a). Since § 549(d) requires an adversary proceeding to be filed to recover such transfers within the earlier of two years from the date of the transfer sought to be avoided or the time the case is closed or dismissed, and no such proceeding has been timely filed in this case, the payments are not recoverable. Third, as there was no showing by interested parties that the funds received either pre- or post-petition were ever property of the estate, the court cannot now require their recovery as an asset of the estate. Fourth, they contend "[t]here is no express prohibition on the payment of funds to professional persons by the debtors after the commencement of the case. In fact, the Bankruptcy Rules clearly contemplate that such payments will be made. See FRBP 2017(b)." Memorandum in Support of Application for Allowance (April 20, 1984), at 3. And finally, they argue that the pre-petition payment they received in the form of a retainer was intended to secure payment of awarded fees, and that they hold a possessory security interest in the retainer and are entitled to offset such retainer against awarded fees. My decision on these defenses precludes the necessity for the court to address the firm's motion for nunc pro tunc appointment as attorneys for the debtors in possession. Further, I will not address the firm's

application as attorney for debtors out of possession as there are insufficient funds to pay any Chapter 11 expenses.

**IT IS NOT INEQUITABLE TO REQUIRE DISGORGEMENT UNDER THE FACTS**

In essence McGavic & Boyd have raised the defense of laches against any order this court might enter requiring it to pay over to the Chapter 7 trustee the funds they obtained from their clients pre- and post-petition. "Laches is one of the affirmative defenses generally allowable under Fed.R.Civ.P. 8(c), although it is properly relevant only where the claims presented may be characterized as equitable, rather than legal." White v. Daniel, 909 F.2d 99, 102 (4th Cir. 1990). It is a defense which is pled against a party within the context of a lawsuit. Here it has been pled as a defense to any order the court might enter requiring disgorgement of fees.

The defense of the laches does not lie against a court. Although the defense of laches does not apply, this court wishes to make a few comments about the allegations of delay. There are two elements to the defense of laches. First, there must be a lack of diligence and unreasonable delay by the plaintiff in the prosecution of his claim. Costello v. United States, 365 U.S. 265, 282, 81 S.Ct. 534, 543, 5 L.Ed.2d 551 (1961). Second, that delay

must be prejudicial to the defendant. Id. McGavic & Boyd have neither stated in what manner there has been an unreasonable delay by the court in this matter nor in what way they have been prejudiced by any delay.

The recited history of the firm's relevant pleadings in this matter makes it abundantly clear that if the court had addressed the firm's fee application shortly after it filed the revised fee application on April 20, 1984, the court would have been reaching a decision on inaccurate and incomplete facts. By 1987 it became clear there would probably be insufficient funds in the estate to pay all Chapter 11 administrative claims and there would possibly be insufficient funds to pay the allowed Chapter 7 administrative claims. The specter of § 726(b) arose at that time. If this court had allowed any fees to McGavic & Boyd in 1984 or 1985, the firm would still be ensnared today by the directive of § 726(b). On the other hand, if in 1984 or 1985 this court, on any legal basis, had directed the firm to repay any or all of the funds it had obtained from its client, it would not have had the use of those funds during the intervening years. Many cases which commence in Chapter 11 and which are converted to Chapter 7 will require several years to administer. On a rare occasion § 726(b)'s requirement that Chapter 7 administrative claims be paid before Chapter 11 administrative claims will force a disgorgement of funds from Chapter 11 claimants several years after their receipt. Although

this may create a cash flow problem for claimants which is not of their making, it is the unavoidable result of the operation of § 726(b). While this court has chosen to order repayment of fees on the basis of Code provisions other than §726(b), in light of the present funds available in this estate to pay Chapter 7 administrative claims the language of that subsection clearly would support an order of disgorgement to carry out its mandate.

This court is a court of equity. It has the power, under § 105(a), to enter orders which may enable a more equitable result under specific circumstances. That section, however, does not authorize the court to create substantive rights nor to ignore the statutory requirements of Bankruptcy Code provisions. See In re Shoreline Concrete Co., Inc., 831 F.2d 903, 905 (9th Cir. 1987); Southern Ry. Co. v. Johnson Bronze Co., 758 F.2d 137, 141 (3rd Cir. 1985). On the other hand, this court is required by the provisions of §§ 326-331 to supervise the appointment and review the compensation of professionals working in the bankruptcy court system. For any number of administrative reasons this review may take place several years after a case commences.

**SECTION 549 DOES NOT PREVENT DISGORGEMENT**

The court has concluded that McGavic & Boyd received at least $4,500 from the debtors in possession after the bankruptcy was

filed.[9] Under § 549 the trustee may recover an unauthorized post-petition transfer of property of the estate. As stated by Judge Radcliffe in In re E Z Feed Cube Co., Ltd., 123 Bankr. 69 (Bankr. D. Or. 1991), this court has an independent duty to examine professionals' fee applications. This duty is not derivative of, or limited by, the trustee's powers under § 549. Id. at 73-74. Further, as E Z Feed points out, "it can hardly be expected that a trustee or debtor in possession would seek to recover unauthorized post-petition transfers of fees [under § 549] made to themselves or their own attorneys." Id. at 73.

**THE POST-PETITION PAYMENTS ARE PROPERTY OF THE ESTATE AND ARE SUBJECT TO BEING DISGORGED**

The firm alleges that the post-petition payments were never property of the estate as they were funds which represented the Thurmonds' post-petition earnings. When an individual debtor files Chapter 11 a unique and difficult issue may arise.[10] Creditors are

[9] In its February 4, 1987 memorandum, the firm asserts it paid $33.33 to a third party for costs. Neither the third party nor the cost item is named. Absent substantiation, this court must assume the firm received the full $4,500.

[10] The problem does not arise in either Chapter 12 or 13 because, although the debtor may continue to operate his business as part of the bankruptcy estate, §§ 1207 and 1306 include earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under Chapter 7 as property of the estate.

paid out of property of the estate.[11] If persons are employed by the estate, it is also property of the estate which the Bankruptcy Code contemplates will be available most often for payment of actual, necessary costs and expenses of preserving the estate, "including wages, salaries or commissions for services rendered after the commencement of the case."[12] Prior to filing Chapter 11 the Thurmonds owned and operated a motel complex as individual proprietors. After filing bankruptcy they continued to run this enterprise as fiduciaries for the estate. A bankruptcy estate consists of all legal or equitable interests of a debtor in the property as of the commencement of the case, with one important exception. Although § 541(a)(6) also includes as property of the estate the proceeds, product, offspring, rents, or profits therefrom, that subsection specifically excepts "such as are earnings from services performed by an individual debtor after the commencement of the case."

There is little case law interpreting the final clause of § 541(a)(6). There is guidance, however, in the Ninth Circuit in In re FitzSimmons, 725 F.2d 1208 (9th Cir. 1984), a case involving the personal post-petition earnings of an attorney. The FitzSimmons court rejected the trustee's argument that §§ 1107 and 1108 entitle

---

[11] Indeed § 726, which establishes the priorities of distribution of assets to creditors in Chapter 7, is denominated "Distribution of Property of the Estate"

[12] See § 503(b)(1)(A).

the estate, not the debtor, to all proceeds from the operation of the debtor's business in Chapter 11, even if they were generated by the individual debtor's services, and held:

> "that § 541(a)(6) excepts from the proceeds of the estate only those earnings generated by services personally performed by the individual debtor. FitzSimmons is thus entitled to monies generated by his law practice only to the extent that they are attributable to personal services that he himself performs. To the extent that the law practice's earnings are attributable not to FitzSimmons' personal services but to the business' invested capital, accounts receivable, good will, employment contracts with the firm's staff, client relationships, fee agreements, or the like, the earnings of the law practice accrue to the estate."

Id. at 1211.

This court is familiar with the premises of the motel complex which was the principal source of the Thurmonds' income. From other case proceedings over the years, this court knows that the motel has many rooms, a restaurant and bar. During its operation in this Chapter 11, the court knows the Thurmonds had a number of employees working at the motel. Income would have been generated at least from lodgings and the sale of food and alcohol. Although the court knows that Mr. Thurmond worked at the motel, it does not know the extent of the personal services he devoted to the business. It does not know if Mrs. Thurmond worked at the motel. McGavic & Boyd have not provided this court with any information which would allow it to ascertain what portion, if any, of the motel's earnings may be attributable to the Thurmonds' personal services. Perhaps more importantly, this court does not know that

there were any "earnings" generated from the Thurmonds' personal services within the meaning of § 541(a)(6) because it has not been demonstrated that the motel generated a profit during any of the time it was operated by the Thurmonds as debtors in possession. This court is aware that for a number of months the business did not generate a profit. In dicta, the FitzSimmons court seems to equate "earnings" with profits in noting the inequity of profits flowing to the debtor while losses are absorbed by the estate. Id. This inequity becomes clear where, in a case such as this, the motel was struggling while the debtors' attorneys received post-petition payments which this court must assume, absent proof to the contrary, would otherwise have been available to aid in financing its operation.

McGavic & Boyd argue that because no interested party has demonstrated these payments were property of the estate, the court cannot require their recovery as an asset of the estate available for distribution to creditors. The firm has cited no authority for this proposition. It is more consistent with the provisions of the Bankruptcy Code to require a professional who represents an individual Chapter 11 debtor as debtor in possession after the case is commenced to demonstrate to the satisfaction of the court and creditors that any post-petition payments to it are not estate assets. When Congress passed the Bankruptcy Code there was particular concern about counteracting the potential for

overreaching by the debtor's attorney at a time when the debtor was in no position to bargain for legal services. It is consistent with that concern that the professional bear the burden of proving that there has been no overreaching contrary to the best interests of the estate and the creditors.

The firm further argues that Bankruptcy Rule 2017(b) "clearly contemplates" that there will be payment of funds to professional persons by debtors after the case is commenced without prior court approval. Bankruptcy Rule 2017 states:

> **Rule 2017. Examination of Debtor's Transactions with Debtor's Attorney**
>
> **(a) PAYMENT OR TRANSFER TO ATTORNEY BEFORE COMMENCEMENT OF CASE.** On motion by any party in interest or on the court's own initiative, the court after notice and a hearing may determine whether any payment of money or any transfer of property by the debtor, made directly or indirectly and in contemplation of the filing of a petition under the Code by or against the debtor, to an attorney for services rendered or to be rendered is excessive.
>
> **(b) PAYMENT OR TRANSFER TO ATTORNEY AFTER COMMENCEMENT OF CASE.** On motion by the debtor or on the court's own initiative, the court after notice and a hearing may determine whether any payment of money or any transfer of property, or any agreement therefor, by the debtor to an attorney after the commencement of a case under the Code is excessive, whether the payment or transfer is made or is to be made directly or indirectly, if the payment, transfer, or agreement therefor is for services in any way related to the case.

Bankruptcy Rule 2017(b) must be read in context with Bankruptcy Rule 2017(a) and § 329, as the rule implements the Code provision. Section 329 applies to payments made, both pre- and

post-petition, by a debtor out of assets which are not property of the estate. It does not apply to the post-petition payments made to the firm by the Thurmonds because at the time the payments were made the Thurmonds were debtors in possession, not debtors, and payments were made out of property of the estate.

Section 1107 describes the rights, powers and duties of a debtor in possession. Section 1107(a) states that a debtor in possession shall have all the rights, other than the right to compensation under § 330, and shall perform all the duties, with a few exceptions not relevant here, of a trustee serving in Chapter 11. Section 327, which is applicable to all chapters, authorizes the trustee or debtor in possession to employ one or more professionals to assist him in carrying out his duties. The debtor in possession employs professionals pursuant to the provisions of § 327. Sections 330 and 331, rather than § 329, establish the requirements for the payment out of estate property of professionals employed by the debtor in possession. Section 330 calls for prior notice and hearing before post-petition payment is made to the debtor in possession's professionals.[13]

It is the position of this court that the requirements of §§ 330 and 331 and the applicable bankruptcy rules dictate the

[13] This distinction is further confirmed by the language of § 1107(b) which states that a person is not disqualified for employment by the debtor in possession under § 327 by the fact that he represented the debtor before the commencement of the case.

following procedures for professionals representing debtors in possession who expect to be paid post-petition out of any funds generated by the debtor in possession post-petition.[14]

1. If the professional expects to receive a post-petition payment for services previously rendered out of property of the estate, he must seek and obtain prior court approval under § 330.

2. This requirement applies although the professional may believe that the funds from which he is to be paid are excluded from the estate by the provisions of § 541(a)(6). That determination is to be made by the court upon evidence presented by the applicant.

3. If, contrary to these requirements, the professional has received any post-petition payment from the debtor in possession without prior court approval, the professional must restore the funds to the estate before he requests that the court approve any fees for services. Restoration is no guarantee of allowance.

McGavic & Boyd did not reveal either their receipt or use of post-petition payments from the Thurmonds to the court until a hearing was held on the objection to their first fee application. The receipt and application of the payments was without prior court

[14] The only exception to this procedure may be that approved by the Bankruptcy Appellate Panel in In re Knudsen Corp., 84 Bankr. 668 (Bankr. 9th Cir. 1988), which allows payment pursuant to § 328(a) prior to final allowance of fees under § 330. Even then prior court approval of the arrangement is necessary and is only allowed in rare cases.

approval. The firm failed to demonstrate that the payments were not from property of the estate. For these reasons this court shall order the $4,500 the firm received post-petition to be refunded to the estate for payment of Chapter 7 administrative expenses.

**THE PRE-PETITION PAYMENTS ARE SUBJECT TO BEING DISGORGED**

The firm's February 4, 1987 supplemental memorandum states that it received $8,200 pre-petition from the Thurmonds, $3,200 of which it applied to their accrued pre-petition fees. It does not specifically address the balance. As earlier stated, this court assumes the balance represents the $5,000 mentioned in the firm's disclosure statement which was to be held for application against post-petition fees as they were incurred.

There is a tension created by the professionals' need to receive payment for their services on a regular basis so as to avoid, in effect, financing a longstanding bankruptcy case and, on the other hand, the duty of the court to assure that payments represent actual, necessary and reasonable compensation for services. This tension has resulted in a number of cases in which the courts have outlined their interpretation of the nature of pre-petition payments made by debtors to their attorneys, and the statutory authority of the courts, as supplemented by the Bankruptcy Rules, to review the payments received.

Section 329 unambiguously requires the attorney representing the debtor, whether or not he applies for compensation under the Code, to file with the court a statement of the compensation paid within one year of bankruptcy for services rendered or to be rendered in contemplation of or in connection with the bankruptcy case. It also unambiguously grants the court authority to review the reasonableness of those payments and order the return of any payments deemed excessive, regardless of the source of the funds. Section 329 is supplemented by Bankruptcy Rules 2016(b) and 2017(a) and (b). The former requires the disclosure statement referred to in § 329(a) to be filed with the court within 15 days of the entry of the order of relief. Section 2017(a), which addresses pre-petition payments, states that the review process may be initiated either by a party in interest or the court sua sponte. It clarifies that any pre-petition payment made in contemplation of the bankruptcy is reviewable. Thus, the § 329 statement, as filed, should disclose the amounts paid to the attorney pre-petition for representation of the debtor in connection with or in contemplation of the bankruptcy, regardless of the source and regardless of whether the payments have been made for such services rendered pre-petition or made for services to be rendered post-petition. All such payments are subject to court review and may be ordered refunded to the appropriate entity to the extent they are found to be excessive.

McGavic & Boyd filed a disclosure statement. Although timely, they did not mention the fees they received from the debtors pre-petition and which they applied to services rendered pre-petition. To date, they have never stated whether the $3,200 so applied was received for services rendered in contemplation of bankruptcy or for nonbankruptcy services performed. They did reveal the $5,000 which they denominated a "partial retainer" for fees to be charged.[15]

A. Retainers[16]

A number of courts have held, some with little or no analysis, that retainers remain property of the estate until earned and

---

[15] The firm also revealed they expected to receive an additional $20,000 in postpetition payments, denominated "retainers". In fact it received only $4,500.

[16] For purposes of this discussion the court defines a "retainer" as a payment for services to be provided in the future. The court in In re McDonald Bros. Construction, Inc., 114 Bankr. 989 (Bankr. N.D. Ill. 1990), identified three types of retainers: the classic retainer; the security retainer; and the advance payment retainer. The classic retainer is one in which a sum of money is paid by a client to secure an attorney's availability over a given period of time. The attorney is entitled to the money regardless of whether he actually performs any services for the client. The security retainer is held by the attorneys to secure payment of fees for future services. It is not present payment for future services. It remains property of the debtor until the attorney applies it to charges for services rendered. An advance payment retainer is payment for services expected to be performed. The parties intend that ownership of the retainer passes to the attorney at the time of payment. McDonald holds that depending upon the nature of the retainer, which in turn depends upon the parties' agreement and state law, the retainer may or may not be property of the estate.

awarded by court order upon application, notice and hearing.[17] Other courts have held that whether a retainer remains property of the estate depends on state law or the intent of the parties under the agreement under which the funds are transferred.[18]

Under the facts before me, it is unnecessary for me to decide whether retainers are always property of the estate. McGavic & Boyd did not furnish this court with a copy of any written agreement they may have entered into with the debtors in contemplation of the debtors seeking bankruptcy protection. In its February 4, 1987 memorandum, the firm stated that the retainer was not property of the estate. In its November 20, 1989 memorandum, the firm stated the retainer represented security for payments to be awarded. These positions are contradictory. The firm could claim either that it held ownership of the funds in hand at the time of filing or that it held only a security interest in those

---

[17] In re Hathaway Ranch Partnership, 116 Bankr. 208, 217 (Bankr. C.D. Cal. 1990); In re K & R Mining, Inc., 105 Bankr. 394, 396 (Bankr. N.D. Ohio 1989); In re C & P Auto Transport, Inc., 94 Bankr. 682, 690 (Bankr. E.D. Cal. 1988); In re Tri County Water Association, Inc., 91 Bankr. 547, 551 (Bankr. D. S.D. 1988); In re Chicago Lutheran Hospital Ass'n, 89 Bankr. 719, 734 (Bankr. N.D. Ill. 1988); In re Leff, 88 Bankr. 105, 107 (Bankr. N.D. Tex. 1988); In re Chapel Gate Apartments, Limited 64 Bankr. 569 (Bankr. N.D. Texas 1986); In re Kinderhaus Corp., 58 Bankr. 94, 97 (Bankr. D. Minn. 1986).

[18] In re Lilliston, 127 Bankr. 119, 121 (Bankr. D. Md. 1991); In re Montgomery Drilling Co., 121 Bankr. 32, 38 (Bankr. E.D. Cal. 1990); In re D.L.I.C., Inc., 120 Bankr. 348, 350 (Bankr. S.D. N.Y. 1990); In re James Contracting Group, Inc., 120 Bankr. 868, 871 (Bankr. N.D. Ohio 1990); In re McDonald Bros. Construction, Inc., 114 Bankr. 989, 997 (Bankr. N.D. Ill. 1990); In re Burnside Steel Foundry Co., 90 Bankr. 942, 945 (Bankr. N.D. Ill. 1988).

funds. It could not do both. Absent proof from the firm that the ownership of the funds representing the retainer passed to the firm at the time of payment, this court must assume that the funds remained the debtors' property and, upon filing, became property of the estate. McGavic & Boyd did not follow the requirements of the Code and Rules in their treatment of the retainer. Bankruptcy Rule 2016(a) instructs that an entity seeking compensation for services from estate property must file a detailed fee application with the court. This application is subject to notice and hearing. Generally, no property of the estate may be applied to fees prior to court review and approval pursuant to § 330. When a debtor's attorney employed under § 327 files either an interim or final fee application subject to the provisions of § 330, he must reveal all pre-petition retainers[19] he has received. Bankruptcy Rule 2016(a). The court is not required to rely on its memory that the retainer may have been revealed on the disclosure statement filed at the beginning of the case. A fee application may be filed many months or even years after the filing of the disclosure statement. If the court reviews and approves a fee award based on an application which does not account for fees paid in the form of a retainer, it may have awarded fees based on a misrepresentation. Upon discovery

[19] "Classic" retainers are not payment for services to be rendered in the future. Whether "classic" retainers are recognized under Oregon law has not been decided. Such retainers should also be revealed to the court for the court's determination as to their legality and reasonableness.

of any misrepresentation, such award would be subject to disgorgement and potential disallowance.

McGavic & Boyd did not reveal the retainer in their first fee application filed with the court on February 14, 1984. Upon creditor objection, they argued they had sufficiently revealed the retainer in their disclosure statement. This argument ignores the unambiguous language of Bankruptcy Rule 2016(a). Further, the firm applied the retainer to its fees incurred prior to court allowance. As the retainer constituted property of the estate, its application to the firm's fees prior to court allowance was in contravention of § 330.

B. Pre-petition Payments Applied for Pre-Petition Services

Section 329(a) requires that an attorney representing a debtor include in his disclosure statement the amounts paid pre-petition for services rendered in contemplation of bankruptcy. This clearly would include payments for services performed on behalf of the debtor in preparation for filing bankruptcy. The reason for such disclosure and court review for reasonableness is that "[p]ayments to a debtor's attorney provide serious potential for evasion of creditor protection provisions of the bankruptcy laws, and serious potential for overreaching by the debtor's attorney, and should be subject to careful scrutiny." House Report No. 95-595 to accompany H.R. 8200, 95th Cong., 1st Sess. 329 (1977). This information must

appear in the disclosure statement whether or not the attorney seeks compensation from the estate through a fee application filed pursuant to Bankruptcy Rule 2016(a).

Funds which the debtor pays pre-petition to the attorney for services rendered pre-petition in contemplation of bankruptcy would not normally become property of the estate. That is because the parties usually intend that upon such transfer, ownership of the funds pass from the debtor to the attorney as a contemporaneous exchange for the services rendered. However, a description of the payment must be included in the disclosure statement because the court is authorized to review the amount of the payment to determine if it was excessive in light of the services provided. Rule 2016(a) also requires that the payment be included in any fee application filed under § 330 or 331 because this information is a vital piece of the complete picture which the judge must have in order to determine what constitutes reasonable compensation to the debtor's attorney for all services in any way connected with the particular bankruptcy.

McGavic & Boyd have taken contrary positions in their memoranda regarding the nature and application of the $3,200 paid pre-petition. On one hand, they alleged the money was applied to fees accrued for services rendered pre-petition. On the other hand, they claimed it was part of the retainer intended as security for fees to be charged. As "retainer" is generally defined, the

$3,200 cannot be part of a "retainer" if applied to fees for services rendered pre-petition.

If the funds were applied as payment for services rendered pre-petition, this court does not know whether the application was on fees accrued for bankruptcy or nonbankruptcy work. Itemized time statements provided to the court reveal the firm worked a number of hours for the debtors in contemplation of bankruptcy. In contrast, because it was not disclosed on the disclosure statement or fee application, as required by § 329(a) and Bankruptcy Rule 2016(a) if paid for bankruptcy services performed, it is logical to conclude they were paid for nonbankruptcy services. The court was not provided any information about whether, at the time of filing, the firm had an outstanding bill with the debtors for nonbankruptcy services. A pre-petition payment by the debtors to the firm for nonbankruptcy services could be subject to avoidance under either § 547 or 548. If pre-petition payments have been made for services rendered in contemplation of bankruptcy under § 329, the court may determine a part of the payments should be refunded as excessive. If it is found that the payments would have been property of the estate absent the transfer, the amount found excessive will be paid to the estate. See § 329(b).

Because McGavic & Boyd failed to reveal the $3,200 in either their disclosure statement or first fee application, and because they have never demonstrated that these funds were applied pre-

petition to services rendered in contemplation of bankruptcy, the court finds the payments must be disgorged under the court's general authority under the Code to review and approve payments made to professionals providing services to the estate.

**MOTION FOR RULE 9011 SANCTIONS**

The movant did not specify the form of sanctions he wishes the court to apply under the circumstances. This court has required disgorgement from McGavic & Boyd of all fees they received for their services to this estate. This disgorgement, although required on another legal basis, is a sufficient "sanction"; further potential sanction is viewed as inappropriate. For that reason the court will deny the motion.

LASWELL ACCOUNTING

Lasswell Accounting was appointed by the court on August 25, 1983 to provide accounting services to the debtor in possession. Sometime thereafter the debtor in possession paid Lasswell Accounting $2,339.15. The court assumes the payment was for services rendered and was paid out of property of the estate.

The professional did not file a fee application with the court nor receive court allowance prior to payment. The attorney for Lasswell Accounting argues that it provided accounting services in

good faith in reliance upon the debtor in possession's attorneys obtaining the necessary authorization for its payment. The court agrees that the debtor in possession's attorney, as the professional in overall charge of the reorganization, either should have taken responsibility for filing the necessary application for payment to Lasswell with the court or clarified with Lasswell that it would be its responsibility to file the necessary pleadings with the court. But this court does not believe that a professional who chooses to be paid from the estate for services it renders to the estate can fairly plead complete ignorance of the rules under which it undertakes its commission. One of the basic, long-standing rules is that professionals are not paid prior to court review of their work and approval of a reasonable fee for the services provided. Failure to obtain review is grounds for reimbursement of the amount paid. Lavender v. Wood Law Firm, 785 F.2d 247 (8th Cir. 1986).

Like McGavic & Boyd, Lasswell's attorney further argues that the trustee may commence an action to avoid post-petition transfers of estate property under § 549 only up to the earlier of two years after the date of the transfer sought to be avoided or the time the case is closed or dismissed. As the transfer in question occurred over four years ago, he asserts the statute precludes its recovery. The court has already rejected that argument.

An appropriate order shall be entered requiring McGavic & Boyd, P.C., and Lasswell Accounting to refund all payments they received from the debtors' Chapter 11 estate to the Chapter 7 trustee.

POLLY S. HIGDON
Bankruptcy Judge